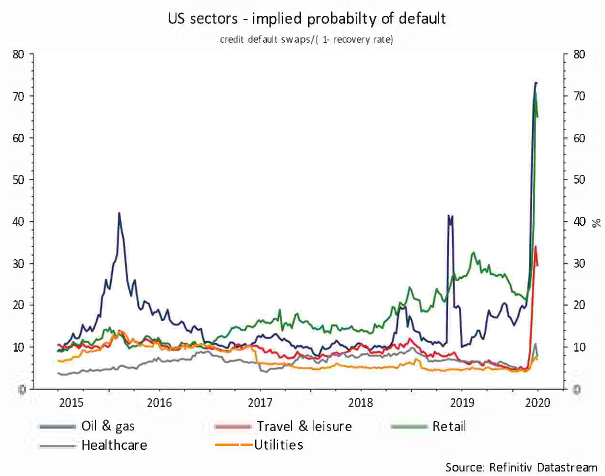
BROMPTON
ASSET MANAGEMENT

Quarterly review for WAY investors

for the three months to 31 March 2020

Countries around the world moved into lock-down during the early spring to combat the Covid-19 pandemic. Complacency that the coronavirus would be contained in a similar manner to severe acute respiratory syndrome (Sars), an Asian coronavirus that infected about 8,000 people in 2003, gave way to panic. Equities plunged before partially recovering in late March to end the quarter down 15.87% in sterling. The global economic impact will be sharp and large but should prove temporary.

Global bonds fell 0.33% in local currencies over the quarter but the pound's fall, 7.02% and 6.40% respectively against the yen and dollar, turned this into a 6.49% gain in sterling. Investors sought sanctuary in traditional safe-haven assets such as gold, which rose 11.66% in sterling although gold equities fell 14.69%. UK government bonds rose 6.97% but sterling corporate bonds and sterling high-yield bonds fell 5.62% and 13.56% respectively as investors demanded higher returns to compensate for default-risk. As the chart below shows, default-risk has risen most sharply for sectors most affected by social distancing and movement restrictions such as retail, travel and leisure. The energy sector has been hurt additionally by the 64.57% oil price fall in sterling in response to the Russo-Saudi price war.



US equities, down 14.10%, were relatively resilient, propped up by technology stocks, down only 5.73%. Many large technology companies have significant cash in their balance sheets and some may benefit from accelerated changes brought about by the lock-downs, including home working and online retailing and entertainment. Polar Capital Global Technology and Fundsmith Equity, which has a large technology allocation, fell only 0.84% and 7.85% respectively.

By contrast, UK equities underperformed, falling 23.92%. The UK stockmarket has a low technology weighting while more cyclical sectors such as financials, industrials and energy account for about half its market value. UK smaller companies did even worse, falling 37.18% principally because of their greater sensitivity to domestic economic trends.

Equities in Asia excluding Japan were relatively robust, falling 12.77% in sterling. Chinese equities fell 4.07% in sterling as new Covid-19 cases slowed and some workplaces re-opened. Chinese policy makers eased monetary and fiscal policy to support a recovery. China's purchasing managers index for manufacturing, a key leading indicator, increased from an historically-low 35.7 reading in February to 52.0 in March, driven by stronger output and new orders. Figures above 50 imply economic expansion is likely. The recovery may prove a template for other economies emerging from lock-down.

Japanese equities fell 11.22% in sterling as local currency falls were partially offset by the stronger yen. Gross domestic product (GDP) fell 1.8% quarter-on-quarter in the fourth quarter of 2019 according to the second estimate and a fall in the most recent quarter would meet the technical definition of a recession.

Europe excluding UK equities underperformed, down 17.33%. The spread on bonds issued by eurozone countries widened on fears that Covid-19 may precipitate the next eurozone crisis. Southern European nations such as Italy and Spain, hard hit by Covid-19, demanded the issue of eurobonds backed collectively by member nations to provide emergency funding, an idea opposed by fiscally-conservative northern countries such as Germany and Holland.

The world's leading central banks responded to Covid-19 by easing monetary policy through interest rate cuts, asset purchases and measures to increase liquidity and stimulate bank lending. US and UK rates were cut to near zero. In the spirit of Ben Bernanke's February 2009 vow to do "everything possible" in response to the global financial crisis, the Federal Reserve said it would purchase assets "in the amounts

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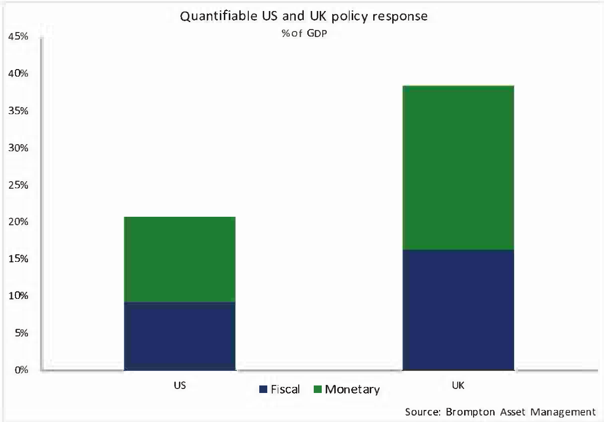
needed" while the European Central Bank committed to quantitative easing "by as much as necessary and for as long as needed".

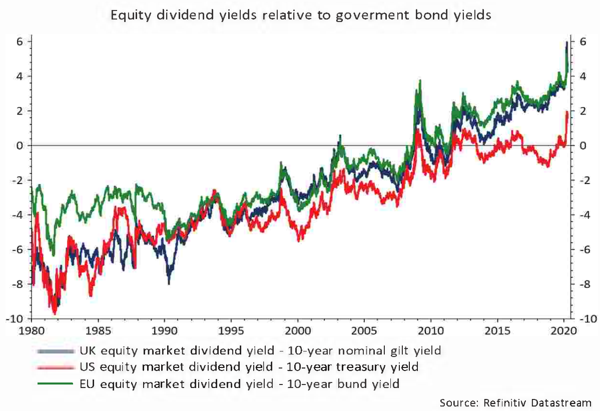
After the 2007-09 financial crisis, new regulations to improve the banking system's resilience required banks to build up capital reserves including specific reserves called counter-cyclical capital buffers, which could be released during financial downturns to maintain credit supplies. In March, the Bank of England reduced banks' counter-cyclical capital buffers to zero, freeing up £190 billion for new lending. During the financial crisis, banks were at the heart of the problem; now lenders may be better placed to mitigate the financial shock.

Monetary policy easing on this scale may bolster confidence and in time aid recovery but measures to stimulate demand may be less effective than fiscal measures aimed at helping businesses and households bridge the liquidity gap until lock-downs are lifted. Governments have, however, committed unprecedented amounts of capital. The US's $2 trillion Coronavirus Aid, Relief and Economic Security Act is a record stimulus package, more than twice the size of the 2009 $831 billion package passed after the financial crisis. The UK government announced £330 billion of loans and guarantees to support businesses, an amount equating to about 15% of GDP; it also unveiled grants to cover 80% of retained workers' salaries and the profits of the self-employed.

The first chart adjacent shows the percentages of US and UK GDP accounted for by the main quantifiable monetary and fiscal easing measures announced in March. The expected drop in global GDP has drawn parallels with the 1930s, a time when there were no automatic stabilisers in the form of welfare spending to cushion the impact. The unprecedented policy response to this crisis coupled with lower energy costs following the large oil price fall should ensure a stronger recovery for businesses and households.



The sharp stockmarket falls left stocks on historically-low valuations at the quarter end as shown in their elevated dividend yields relative to risk-free assets such as government bonds - see chart below.



There will be more profit warnings and dividend cuts but quarter-end valuations appeared to imply businesses would suffer a permanent, not temporary loss of earnings. The downturn will be severe but sufficient policy response is in place or likely to be forthcoming to ensure viable businesses survive and can return to historic levels of profitability. In consequence, equity markets should offer good buying opportunities for longer-term investors.

Important information

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